University of the Philippines
SCHOOL OF ECONOMICS

Discussion Paper 8102 February 1981

THE CORPORATE INCOME TAX: ITS DISTRIBUTIVE IMPLICATIONS ON INDIVIDUAL SHAREHOLDERS

by

Nilda D. Vasquez

Abstract

Under the present system of income taxation in the Philippines, there is a differential burden created by the corporate income tax on shareholders' incomes vis-a-vis other types of personal income. Corollarily, within the corporate sector, a built-in incentive exists in favour of debt finance, but the role of this factor in the corporate choice between equity and debt finance has not been empirically established.

Another major equity issue is the regressivity of the differential burden of the corporate tax among shareholders. This extra burden may eventually turn into a tax shelter for high-income taxpayers, creating a strong inducement for tax avoidance by capitalizing on the corporate device through retention of corporate profits. The proposed 20 percent final tax on dividends, which is part of the gross income package proposed under Cabinet Bill No. 34, is a tax in rem and will intensify the existing regressivity.

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I. Introduction

The protean nature of the corporate income tax renders its analysis a formidable task. The distributive or equity aspect alone is so intricately interwoven with personal income taxation and the question of corporate tax shifting and incidence, the latter being the most important unsettled controversy in the area of tax incidence.

This paper examines a facet of the equity issue in corporate income taxation -- the differential burden of the tax and its distribution among stockholders. Inevitably this will also involve personal income taxation insofar as shareholders are liable to both the personal income tax on dividends received and to the corporate income tax on their share of the corporate gross profits. The equity issue revolves around, and arises from, the so-called "double taxation" of their distributed corporate earnings.

The distributive implications of corporate income tax cum personal income tax on dividends are analyzed along two lines: the non-neutrality in tax treatment of corporate profits vis-a-vis other sources of personal income, and the distribution of the

burden of the corporate income tax among individual stockholders belonging to different income groups. It will be shown that the corporate income tax in the Philippines imposes a differential burden which is regressive and creates a strong incentive for tax avoidance. In the light of the foregoing analysis, the paper finally examines the proposed amendment to the taxation of dividends as part of the Gross Income Package Proposal submitted to the Interim Batasang Pambansa as Cabinet Bill No. 34.

II. The Double Taxation of Distributed Corporate Profits

A. Tax Burden Differential Between Corporate Earnings and Other Incomes

A major recurring point of controversy in corporate income taxation is that the stockholder's dividend income is taxed twice: first at the corporate level through the corporate income tax, and again at the hands of the stockholder when the dividend income becomes liable to the individual income tax. This effective double taxation renders the tax treatment of dividends unique compared with other sources of personal income, notably non-corporate profits, or non-profit corporate-source income like interest earnings on corporate debt issues.

There are two schools of thought on this matter. One is the absolutist view, which regards the interests of the corporate

enterprise as separate from those of its stockholders, and therefore, justifies its taxation as a separate entity. On the other hand, the integrationists hold that the present system of double taxation is inequitable because it creates a difference in tax burden whether greater or less, between the stockholder and a non-stockholder receiving the same amount of income.

There is much sense in the integrationist view. On equity grounds, an absolute, impersonal tax on the income of the corporate enterprise cannot be justified because it does not have a separate ability to pay or a taxpaying capacity. "Corporate profits are part of the income of the shareholders and, in the spirit of the accretion approach to the income tax should be taxed as part of their income. There is no reason why they should either bear an extra tax or be given preferred treatment" (Musgrave and Musgrave, 1976).

For income tax purposes, there exists neither a strong nor clear basis in viewing the corporation as other than an income conduit for its stockholders; the corporate profits accrue to them in the same sense that profits accrue to the sole proprietor. Its existence as a separate legal personality does not ipso facto bestow on it an ability to pay apart from that of its owners.

To illustrate: under the present system, given two single taxpayers A and B receiving a gross income each of ₱5,000 from dividends (A's corporation is taxable at 25%) and from salary,

respectively, and assuming the optional standard deduction of 10 percent or ₱500 plus a personal exemption of ₱1,800, the individual income tax liability for each is ₱102, and the disposable income ₱4,898. However, an inequity arises from the fact that A's income has already been taxed at the corporate level, the size of this previous tax bite depending on the taxable bracket applicable to A's corporation. Without the corporate tax of 25 percent, and assuming for simplicity full distribution and optional standard deduction, A's gross dividend income would have been ₱6,666.67 and the corresponding tax liability on that income, ₱440.04. This would then have left A with disposable income of ₱6,226.63. Or to take another example, if C's gross income from dividend under a system of no corporation tax and full distribution were ₱5,000, the imposition of a 25 percent corporate tax would reduce this to ₱3,750. Again with the above assumptions of 10 percent optional standard deduction and personal exemption of ₱1,800, the personal tax bite would be ₱47.25, giving an after-tax income of ₱3,702.75. Finally, due to recent tax amendments, a further comparison need be made with interest income on savings deposits, time deposits, and deposit substitutes. In accordance with the latest Presidential decree on taxation, Presidential Decree No. 1739 (dated 17 September 1980), the tax-take from another taxpayer, D, on interest income of ₱5,000 on savings deposits is 15 percent or ₱750. On an equivalent amount of interest income, but on time deposits or deposit substitutes, still another taxpayer, E, has to pay a tax of 20 percent or ₱1000. These new rates are effective 1 January 1981.

B. Equity vs. Debt Capital

A related aspect of the double taxation of corporate-source profit is the inevitable built-in discriminatory treatment between dividend and interest income, and therefore, between share-owners and creditors of the corporation. This arises because interest payments are deductible as an expense, but not dividends as return to equity capital. The corporate income tax then creates a differential between the rates of return on equity and on other capital.[1] The implication will vary, depending on the assumption made. If potential stockholders make their purchase on the basis of pre-tax corporate earnings per share, then there is heavier taxation of income from equity capital relative to income from debt capital; the stockholder realizes a lower net rate of return than the owner of corporate bonds.

On the other hand, it is argued that capitalization of the corporate income tax is done, that is, the shareholder discounts the tax in the purchase price of the stock, and looks at the

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[1] For a discussion of the so-called "excise-tax effects" of the corporate income tax brought about by this differential, see Harberger (1959).

after-tax rates of return between equity and debt capital. If in long-run equilibrium, these two tend to be equalized (after allowing for risk factors), it becomes more expensive for the corporation to raise funds through equity issues than debt issues such as bonds. Thus, in the Philippines, the corporation must be able to earn approximately at least ₱1.33 to pay ₱1 of dividend, whereas it needs to earn only ₱1 to pay interest of ₱1.[2] This creates a built-in bias in favor of debt financing vis-a-vis equity financing. It is feared that this may cause "undue concentration on debt financing which may significantly circumscribe the company's flexibility and willingness to undertake new and relatively risky ventures and limit its ability to adjust readily to changing business conditions" (Staff Report for the Joint Economic Committee, 1961).

In answer to this, it has been pointed out that tax considerations are not all that significant in determining the type of financing chosen by the corporation. Rather, a major limitation on equity

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[2] From mid-1977 to December 1980, however, in the case of commercial papers issued in the primary money market as money instruments, corporate borrowers had to pay a 35 percent transaction tax on the gross amount of interest, and therefore must earn ₱1.35 for every ₱1 paid out as interest. The tax, which was paid by the borrower, was final and deductible for income tax purposes. See Sec. 210 (b), National Internal Revenue Code of 1977. Presidential Decree No. 1739 has abolished this tax, imposing instead a tax of 20 percent on yield from deposit substitutes received by individuals and corporations. Since the latter tax is a final tax paid by the lender and withheld at source, corporate borrowers issuing said deposit substitutes in effect again have to earn only ₱1 to pay ₱1 of interest. (See Secs. 2, 3 and 13 of P.D. No. 1739). According to the Implementing Regulations of the Bureau of Internal Revenue this new tax on deposit substitutes is to be imposed from 1 January 1981.

financing lies in the desire of existing stockholders to minimize dilution of their interest through increased equity issues.

Another principal determinant of the type of corporate financing is the character of the market for the supply of capital funds. This market, which is dominated by institutional investors like commercial banks, savings banks, and insurance companies, etc., may be restricted by law or traditional investment practice, to high-grade bonds.

Further, it is argued that the supposed adverse effects of debt financing (allegedly induced by tax considerations) on the willingness of corporations to go into high-risk ventures may be unduly exaggerated. On this score, it is said that a majority of the highly speculative investments have in fact been financed with only a little equity, and that what impels this type of financing is precisely the prospect of high returns on this equity through the leverage created by debt financing. Lastly, it is claimed that a major portion of the capital funds required by corporations are raised internally and therefore no unbalance in favor of debt financing is actually discernible in corporate financial structures. (Staff Report for the Joint Economic Committee, 1961).

Any conclusion that the differential tax treatment between dividend and interest payments impels corporations to prefer debt, rather than equity, financing has to be substantiated by empirical evidence. Economic theory can at best provide only a rather

agnostic conclusion. The tax factor is only one of several determining the level of corporate debt. How important it is cannot be determined a priori. Due to the usual dearth of data on the corporate sector, no light can be shed at present on this matter as far as the Philippines is concerned. It remains one of the unexplored issues in corporate income taxation in this country.

In the United States, empirical studies suggest that there has been no convincing evidence on the impact of corporate income taxation on corporate financial policy: the composition of new corporate funds shows poor correlation with changes in tax rates (Staff Report for the Joint Economic Committee, 1961).

In addition, a study which looked into the corporate puzzle of equity vs. debt financing based on tax considerations revealed that the equilibrium situation is a much more complex relationship than simply the average costs of debt vs. equity financing (Tambini, 1969). This should be examined within the analytical framework of the neoclassical theory of the firm, which considers that the crucial variables in determining this equilibrium are the marginal cost of debt, the marginal cost of equity, and the marginal rate of return on investment. Tax provisions certainly affect these variables: these include not only the taxation of dividends compared to the deductibility of interest expenses, but also capital gains provisions. The latter affect the marginal cost of equity

depending on the importance of the marginal tax rate on dividends relative to the marginal tax rate on capital gains.

Apropos this last consideration, preferential tax treatment in the Philippines has generally been accorded to long-term capital gains realized by individuals, only 50 percent of which is taxable (Sec. 34, NIRC) as compared with dividend income, which is subject to the ordinary marginal tax rates ranging from 3 percent to 70 percent. Further, Presidential Decree 1739 also imposes a 10 percent final tax on capital gains from the sale or exchange of shares of stock. (However, if the shares of stock are in a close corporation, capital gains in excess of ₱50,000 are taxed at 20 percent.) This tax took effect 1 January 1981, replacing the stock transactions tax of 1/4 of one percent of the gross selling price or value of stocks exchanged or transferred (Sec. 210, NIRC).[3]

III. Distribution of the Burden of the Corporate Income Tax Among Stockholders

The other significant equity issue in corporate income taxation involving stockholders is the distribution of the tax burden among stockholders belonging to different income groups or marginal tax rate brackets. Three concepts of burden of the corporate tax are

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[3] Imposed in 1977, the stock transactions tax was paid by the seller in lieu of the capital gains tax otherwise due under Sec. 34 of the NIRC.

discussed, namely, gross, net, and extra.

The following analysis of the tax burden distribution under the Philippine income tax system is essentially patterned after the model made by Musgrave and Musgrave (1976) and incorporates the following assumptions:

1. There is no shifting of the corporate income tax, either forward or backward.

2. Gross corporate profit share is a rising proportion of shareholders' gross incomes.

3. The present stockholders have not employed tax capitalization, i.e., the purchase price of the shares has not been made lower by the present value of all the expected future tax payments.

4. Only ordinary corporations, both domestic and resident foreign, are considered, on which the applicable corporate tax rates are 25 percent (on the first ₱100,000 of net taxable income), and 35 percent (on the amount in excess of ₱100,000), and the additional 5 percent corporate development tax.[4]

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[4] This additional tax is imposed by the NIRC (Sec. 24(e) on a) a domestic corporation whose net income exceeds 10 percent of net worth, b) a resident foreign corporation whose net income exceeds 10 percent of its net assets in the Philippines, and c) a closely-held corporation as defined by the NIRC, Sec. 24(e).

5. For computational simplicity, the shareholders are resident citizens or aliens.

6. Intercorporate dividends (which are taxable at a different rate) are not considered.

7. Interest income is taxable as ordinary income; more precisely, the interest considered here does not fall within the scope of P.D. 1739 previously mentioned which imposes a final withholding tax on certain types of interest receipts.

A. The Gross Burden

The money burden may first be considered in gross terms, that is, independent of the shareholder's individual income tax liability (and hence marginal tax rate bracket). If the tax falls on corporate profits which are assumed to be a rising proportion of the shareholder's gross income as the latter rises, then the pattern of distribution of gross burden of the tax is progressive: the effective corporate income tax rate (in relation to gross income) increases as gross income increases.

The following table illustrates gross burden progressivity under the present system. As shown in line 1, taxpayers' reported gross incomes (GI) range from ₱4,000 to ₱3,000,000.[5] The dividend

[5] For income tax purposes the relevant gross income is not the sum of all incomes, because it excludes incomes exempt from tax by law. The exclusions from gross income are given in Section 29 of the NIRC, as amended.

Table 1

GROSS BURDEN OF CORPORATE INCOME TAX

Items	Taxpayer									
	A	B	C	D	E	F	G	H	I	J
1. Marginal Tax Rate (%)	3	6	12	20	30	50	60	68	69	70
2. Gross Income, GI (₱)	4,000	20,000	40,000	60,000	100,000	300,000	500,000	1,000,000	2,000,000	3,000,000
3. Dividends as % of GI	2	3	5	7	10	12	15	18	20	25
4. Dividends (in ₱)	80	600	2,000	4,200	10,000	36,000	75,000	180,000	400,000	750,000
5. Retained Earnings (in ₱)	240	1,800	6,000	12,600	30,000	108,000	225,000	540,000	1,200,000	2,250,000
6. Corporate Tax (in ₱)	172.80	1,296	4,320	9,072	21,600	77,760	162,000	388,800	864,000	1,620,000
7. Gross Profit Share (in ₱)	492.80	3,696	12,320	25,872	61,600	221,760	462,000	1,108,800	2,464,000	4,620,000
8. Imputed GI (₱)	4,492.80	23,696	52,320	85,872	161,600	521,760	962,000	2,108,800	4,464,000	7,620,000
9. Gross Profit Share as % of Imputed GI	10.97	15.6	23.5	30.13	38.12	42.5	48.02	52.58	55.2	60.63
10. Average Rate of Corporate Tax, with respect to Imputed GI (%)	3.85	5.46	8.26	10.56	13.37	14.90	16.84	18.44	19.35	21.26

Assumptions:

1. Dividend income increases as a proportion of gross income.

2. Retained earnings = 3/4 of profits after corporate income tax, or dividend payout ratio = 1/4

3. Corporate income tax rate, t_c = 35%
The corporate tax T paid by the stockholder is then determined as follows:

$$T = t_c (D + R + T)$$
$$= .35 (D + R + T)$$
$$.65\ T = .35 (D + R)$$
$$T = \frac{.35}{.65} (D + R)$$
$$T = .54 (D + R)$$

4. Further, taxable income and therefore the marginal tax rate are directly related to gross income. This is not necessarily true, depending on the size of the actual deductions allowed. On the other hand, there is no reason for supposing that the contrary assumption is itself true. In the absence of any relationship unequivocally established by empirical data, the direct relationship has been assumed.

5. The higher corporate income tax rate of 35% has been assumed, rather than only 25%, because as corporate income increasingly goes beyond ₱100,000, the effective rate tends to approach 35%. Further, where the additional corporate development tax of 5% is applicable, the effective rate is closer to 35% rather than to 25% when the corporate profits exceed ₱100,000.

incomes in line 4 are based on the arbitrarily assumed rising percent share of dividends in gross income (GI). The higher corporate income tax rate of 35 percent is applied here for computational ease and because, the greater the taxable profit exceeds the ₱100,000 level taxable at 25 percent, the closer the effective tax rate approaches the rate of 35 percent. Moreover, the corporate development tax, where applicable, places the effective rate closer to 35 percent than to 25 percent if the taxable net income exceeds ₱100,000. The retained earnings are assumed to be three quarters of profits after tax, hence the dividend payout ratio (after tax) is one quarter. The corresponding retained earnings accruing to the shareholder and the corporate tax bite on his gross profit share are given in lines 5 and 6, respectively. The Gross Income as imputed (shown in line 8) includes his share of retained earnings and corporate income tax. Finally, the average rate of the corporate income tax is derived by dividing the corporate tax by the imputed GI. The resulting ratio is the effective gross burden of the corporate income tax shown in line 10. This is clearly progressive, rising from 3.85 percent for the lowest imputed GI of ₱4,492.8 to a little more than 21 percent for the top income shareholder with imputed GI of ₱7,620 thousand.

B. The Net Burden

The gross burden of the tax as illustrated above is not quite an accurate picture of the burden distribution. It considers only the corporate income tax by itself, and not in relation to the individual income tax liability of the stockholder. The latter must also be taken into account to determine the net burden (or incremental burden) of the corporate income tax.[6] The hypothetical data on gross profit share and imputed GI derived in the gross burden case will be adopted here. In addition, the individual marginal tax rates will be brought into the analysis to determine the hypothetical personal income tax liabilities of the stockholders.

The measurement of the net burden of the corporate income tax proceeds in this manner: a comparison is made between the joint or combined corporate-personal income tax applicable at present on the distributed corporate earnings share of the stockholder, and the tax payable if this distributed corporate earnings share had been fully liable to the personal income tax alone. The difference between the combined, or joint corporate - personal income tax and the notional personal income tax is the net or incremental burden of the corporate

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[6] Joseph Pechman refers to this concept as the additional burden of the corporate income tax. He assumes zero retention, or full distribution of after-tax corporate profits.

income tax. It consists of two parts: the additional tax imposed by the corporate tax, and a tax saving. Inasmuch as the dividends are reduced by the corporate tax, the personal income tax payable on the dividend income is likewise reduced. It follows that this tax saving for each ₱100 of dividends will be higher for a higher income shareholder than for a low-income dividend recipient because the former's marginal tax rate is also higher.[7] Since this tax saving increases with the stockholder's income, the resulting net tax per ₱100 of profits is easily seen to fall as one moves up the income scale.

The net or incremental tax burden of the corporate tax which is equal to the joint corporate-personal income tax minus the hypothetical or notional personal income tax if no corporation tax were imposed, is given by the following formula (Musgrave and Musgrave, 1976):

$$T_j = t_c P + t_p d (1 - t_c) P$$

$$T_p = t_p dP$$

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[7]Hence, with full distribution and no corporate income tax, the personal income tax payable by a stockholder in the 20 percent marginal tax rate bracket for each additional ₱100 of profit share would be ₱20, and for one in the 70 percent bracket it would be ₱70. With a corporate tax of 25 percent, also assuming full distribution, the first stocholder would pay a personal income tax of ₱15, and the second one, only ₱52.50. This would bring the personal income tax saving to only ₱5 for the lower income stockholder, and ₱17.50 for the top income stockholder.

$$T_n = T_j - T_p$$

$$= t_c P + t_p d (1 - t_c) P - t_p dP$$

$$= t_c P (1 - dt_p)$$

where T_j = joint corporate-personal tax

T_n = net burden of the corporate income tax

t_c = corporate tax rate

t_p = applicable individual income tax rate (marginal)

d = percentage of after-corporate tax profits paid out as dividends

P = taxpayer's share in before-tax corporate profits

The declining absolute net burden of the corporate income tax per ₱100 of profit as stockholder income increases is seen in Table 2. The reported GI and the gross profit share (lines 1 and 2) are taken from Table 1. The corresponding marginal tax rates are given in line 3. The net burden distribution is examined for three dividend payout ratios namely, zero, 25 percent, and 100 percent. To illustrate: with 25 percent distribution under the present tax system, the dividend after payment of corporate income tax for each ₱100 of profits is ₱16.25. The individual income tax liability on this same amount of dividends will then vary with the stockholder's marginal tax rate. Thus, for the dividend recipient at the bottom bracket of 3 percent, the tax due is only ₱.49, compared with ₱11.38 for the

top income shareholder. The combined tax (line 8) is the sum of the corporate tax of ₱35 (line 5) and the individual income tax applicable on the dividend (line 7). In the table, this ranges from ₱35.49 to ₱46.38. On the other hand, the individual income tax bite in the absence of the corporate tax, still with 25 percent payout, starts from ₱.75 at the bottom bracket and steadily increases to ₱17.50 at the top of the scale (line 1). The net tax for every ₱100 of profits is then derived by subtracting this notional individual income tax from the combined corporate-individual income tax, as shown in line 11. As explained earlier, this falls as shareholder income rises: in this case from ₱34.74 to ₱28.88.

A declining net tax burden for each additional ₱100 of profits as income rises does not in itself indicate regressivity of the corporate income tax among stockholders. As stressed by Musgrave and Musgrave (1976), "the net burden impact must be measured by the ratio of the taxpayer's total net tax to total income. Hence, this ratio is a function both of the net tax per ₱100 of profits and the profit component of total gross income. The falling net tax per ₱100 of profits makes for regressivity, on one hand, and a rising gross profit component of total gross income makes for progressivity,[8] on the other. The effective

[8]This is because an increasing proportion of total income is subject to both the corporate and the personal income tax, or, more precisely, to a net burden of the corporate income tax per ₱100 of profits.

NET BURDEN OF CORPORATE INCOME TAX

	Items	Taxpayer A	B	C	D	E	F	G	H	I	J
1.	Imputed GI (₣)	4,492.8	23,696	52,320	85,872	161,600	521,760	962,000	2,108,800	4,464,000	7,620,000
2.	Gross Profit Share (₣)	492.8	3,696	12,320	25,872	61,600	221,760	462,000	1,108,800	2,464,000	4,620,000
3.	Bracket rate (%)	3	6	12	20	30	50	60	68	69	70
4.	Gross Profit as % of Imputed GI (%)	10.97	15.6	23.5	30.13	38.12	42.5	48.02	52.58	55.2	60.65
	I. Twenty-Five Percent Distribution										
	Present System										
5.	Corporate Income Tax (₣)[a]	35	35	35	35	35	35	35	35	35	35
6.	Dividends (₣)[a]	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25
7.	Individual Income Tax (₣)[a]	.49	.98	1.95	3.25	4.88	8.12	9.75	11.05	11.21	11.38
8.	Combined Tax (₣)[a]	35.49	35.98	36.95	38.25	39.88	43.12	44.75	46.05	46.21	46.38
	Without Corporate Income Tax										
9.	Dividends (₣)[a]	25	25	25	25	25	25	25	25	25	25
10.	Individual Income Tax (₣)[a]	.75	1.5	3	5	7.5	12.5	15	17	17.25	17.5
11.	Net Tax (₣)[a]	34.74	34.48	33.95	33.25	32.38	30.62	29.75	29.05	28.96	28.88
12.	Total Net Tax on Gross Profit Share (₣)	171.27	1,274.38	4,182.64	8,602.44	19,946.08	67,902.91	137,445	322,106.4	713,574.4	1,334,256
13.	Total Net Tax on Gross Profit Share, as Percent of Imputed GI (%)	3.81	5.38	7.99	10.02	12.34	13.01	14.29	15.27	15.99	17.51

[a]Per ₣100 of Profits.

Table 2 (Cont'd.)

Items	Taxpayer A	B	C	D	E	F	G	H	I	J
				II. Zero Distribution						
14. Corporate Income Tax[a]	35	35	35	35	35	35	35	35	35	35
15. Individual Income Tax (₱)[a]	0	0	0	0	0	0	0	0	0	0
16. Combined Tax (₱)[a]	35	35	35	35	35	35	35	35	35	35
17. Net Tax Per ₱100 of Profits (₱)[a]	35	35	35	35	35	35	35	35	35	35
18. Total Net Tax on Gross Profit Share (₱)	172.55	1,293.6	4,312	9,055.2	21,560	77,616	161,700	388,080	862,400	1,617,000
19. Total Net Tax on Gross Profit Share as % of Imputed GI (%)	3.84	5.46	8.24	10.54	13.34	14.88	16.81	18.40	19.32	21.22
Present System				III. Full Distribution						
20. Corporate Income Tax (₱)[a]	35	35	35	35	35	35	35	35	35	35
21. Dividends (₱)[a]	65	65	65	65	65	65	65	65	65	65
22. Individual Income Tax (₱)[a]	1.95	3.90	7.80	13.00	19.50	32.50	39.00	44.20	44.85	45.50
23. Combined Tax (₱)[a]	36.95	38.90	42.80	48.00	54.50	67.50	74.00	79.20	79.85	80.50

[a]Per ₱100 of Profits.

Table 2 (Cont'd.)

[a]Per ¥100 of Profits.

Table 2 (Cont'd.)

Items	Taxpayers A	B	C	D	E	F	G	H	I	J
Without Corporate Income Tax										
24. Dividends (¥)[a]	100	100	100	100	100	100	100	100	100	100
25. Individual Income Tax (¥)[a]	3.00	6.00	12.00	20.00	30.00	50.00	60.00	68.00	69.00	70.00
26. Net Tax (¥)	33.95	32.90	30.80	28.00	24.50	17.50	14.00	11.20	10.85	10.50
27. Total Net Tax on Gross Profit Share (¥)	167.37	1,215.98	3,794.56	7,244.16	15,092	38,808	64,680	124,185.6	267,344	485,100
28. Total Net Tax as % of Imputed GI (%)	3.73	5.13	7.25	8.44	9.34	7.44	6.72	5.89	5.99	6.37

rate will then depend on the relative magnitudes of these two opposing elements.

In absolute terms the total net tax burden on the gross profit share increases with income, as shown in line 12. This follows necessarily from a positive, though decreasing (except of course for zero distribution), net tax burden per ₱100 of profits and a rising profit component of shareholder income (as income increases).

With zero and 25 percent dividend pay-out ratios, the progressivity in net burden distribution (as indicated by the behaviour of the ratio of total net tax on gross profit share to imputed GI) is marked over the entire range. The pattern is more progressive under zero distribution as may be expected, since there is no individual income tax saving on dividend income. Under full distribution the net burden is progressive at the outset, then becomes regressive, as can be seen in line 28. The declining net tax per ₱100 of profit assumes increased importance, thus making for regressivity at this higher income range.

C. The Extre Burden

A further refinement must be made to achieve a more precise pattern of the distributional tax load of the corporate income tax among different income-bracket stockholders. It now calls for the adoption of an integrated approach in the sense that the individual's

total share of corporate profits is treated as part of his personal income. This is called the partnership method because the stockholders are treated as "partners," as it were, in the corporate enterprise. It is the approach adopted by Musgrave and Musgrave (1976), Holland (1958), Pechman (1971), and others, in analyses of this kind.

Using this approach, we come up with the concept of the "extra burden" of the corporate income tax. The size of the "extra tax" can be determined by comparing the present combined corporate-personal income tax on dividends and the tax due if there were no corporate income tax and the individual income tax were to apply to distributed and undistributed profits. Hence its magnitude is the difference between the joint tax and the notional personal income tax that is otherwise applicable on the corporate profits share in the absence of the corporate income tax. Alternatively, it is the corporate tax less the personal tax due on the corporate tax (Holland, 1962).

The position adopted in this case is that, for purposes of tax burden comparison, both distributed and undistributed corporate earnings should be taken as allocable to the individual stockholders in the different income tax brackets. This method of imputing all corporate earnings - corporate taxes, dividends, and undistributed profits - to the individual owners of corporate

stocks in determining the distribution of the corporate tax load among stockholders is mainly for analytical purposes. It carries no prescriptive implication "as to the desirability or feasibility of treating the owners of corporation as members of a partnership... The sole reason for using the device of imputation is the belief that the quantitative weight of the special tax treatment of corporate earnings can best be measured by relating this income share to the income level of its claimants" (Holland, 1958). As will be apparent, the notion of the extra tax will shed reconciliatory light on two seemingly disparate views: one, that the stockholder incurs a pecuniary loss due to double taxation of dividends, and the other, that the corporate device yields a pecuniary advantage to the stockholder in the form of a tax shelter created by retaining corporate profits otherwise taxable at individual marginal rates.

The extra tax, T_e, is the difference between the combined or joint tax T_j and the integrated tax T_i which is the notional personal income tax on the entire gross profit share. Thus, using the same notation as for the net burden case, we have the following formula for the extra tax (Musgrave and Musgrave, 1976):

$$T_e = T_j - T_i$$

$$T_j = T_c P + t_p d (1 - t_c) P$$

$$T_i = t_p P$$

$$T_e = t_c P\, t_p d\,(1 - t_c)\, P - t_p P$$

$$= [t_c + t_p d\,(1 - t_c) - t_p]\; P$$

Relating this to the net tax, we can see that

$$T_e = T_n - t_p\,(1 - d)\,P,$$

$$\text{or } T_n = T_e - t_p P\,(1 - d)$$

The extra tax gives rise to two major equity implications. One is the difference in tax liability between corporate-source income, on one hand, and other sources of personal income of the same amount, on the other. As discussed earlier, the non-neutrality of the corporate profits tax -- in that it applies only to returns on corporate equity capital and not to corporate borrowed capital, profits outside the corporate sector, nor to other types of earnings --- creates a built-in differential under the present system of double taxation. On equity grounds, the justification for a differential tax liability between corporate-source profit and, say, interest income is rather obscure. Under an integrated system, on the other hand, this differential would be eliminated; the stockholder's share of corporate earnings, whether retained or paid out, would be liable to the same amount of tax as income from another source. To illustrate: at present an individual shareholder in the 20 percent marginal tax bracket

pays in effect a tax of ₱.38 for each additional peso of corporate income (assuming a 25 percent dividend payout ratio) compared with ₱.20 for each additional peso of interest income. The ₱.18 constitutes the differential or "extra tax" which would be eliminated if the corporate income tax were to be fully integrated with the personal income tax. The extra tax may be positive or negative, depending on the shareholder's marginal bracket rate.

The other equity implication lies in the pattern of distribution of the extra burden of the corporate tax among the stockholders belonging to different income brackets. The extra tax per ₱100 of profits varies inversely with income. It will be recalled that this is also true for the net burden case for all positive payout ratios. The extra tax per ₱100 of profits declines as one moves up the income scale for the same reasons as in the net tax case, and for zero as well as positive dividend distribution. It is clear from a comparison of the two that the extra tax is less than the net tax, except for full distribution. For the zero and 25 percent distribution, the extra tax eventually becomes negative with higher incomes. Thus, as the shareholder's marginal bracket rate goes up, the extra tax eventually turns into a tax shelter. This arises in a situation where

$$t_p > t_c + t_p d (1 - t_c)$$

or

$$t_p > \frac{t_c}{1 - d (1 - t_c)}$$

At a 25 percent dividend payout ratio, a bottom-bracket stockholder pays approximately an additional thirty two centavos (₱.32) per peso of corporate-source income since the joint corporate-personal income tax is ₱.35, but his tax liability on a different type of income[9] of the same amount would be only three centavos (₱.03). In constrast, a top-bracket stockholder pays in effect less tax per peso of corporate income than what he would be paying on another type of income; on corporate profits his combined corporate-personal income tax is about forty-six centavos (₱.46), or twenty-four centavos (₱.24) less than the tax of seventy centavos payable on interest or non-corporate profits. The low-income stockholder incurs an extra burden or loss, whereas his top-bracket counterpart enjoys an effective subsidy from the tax shelter under the present scheme.

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[9] This excludes those incomes which have been specifically given preferential treatment, like long-term capital gains, and those invested in preferred enterprises, banks, and non-bank financial intermediaries, under certain conditions.

The differential tax load for the extra burden concept is illustrated in Table 3, again under three different assumptions of after-tax corporate profit distribution, namely, zero, 25 percent, and 100 percent. The combined corporate-personal income tax payable under the present system is compared with the notional tax liability under the personal income tax alone, assuming a full pro rata share of stockholders in corporate earnings. As expected, the resulting pattern is a function of the payout ratio. For all three assumed ratios, the extra tax per ₹100 profit decreases as income increases (shown in lines 9, 13, and 20, respectively). This is least under zero distribution and becomes negative at a marginal bracket rate lower than is the case with 25 percent payout ratio. In our example the tax shelter for zero distribution arises once the bracket rate exceeds 35 percent.[10] Further, not surprisingly, the pattern is most regressive under zero distribution, since the savings in personal income tax arising from retention are greatest. With a payout ratio of 25 percent, the situation becomes one of deficient taxation beyond the marginal tax bracket rate of 42 percent. Under full distribution, the extra burden remains positive, and the total extra tax on the gross profit share as a ratio of imputed GI exhibits progressivity for a wide range of

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[10] However, there is no 35 percent marginal tax rate bracket in the present individual income tax rate structure.

Table 3

EXTRA BURDEN OF THE CORPORATE INCOME TAX

	Taxpayer									
	A	B	C	D	E	F	G	H	I	J
	4,492.8	23,696	52,320	85,872	161,600	521,760	962,000	2,108,800	4,464,000	7,620,000
hare (¥)	492.8	3,696	12,320	25,872	61,600	221,760	462,000	1,108,800	2,464,000	4,620,000
ate (%)	3	6	12	20	30	50	60	68	69	70
f										
	3	6	12	20	30	50	60	68	69	70
				I. Twenty-five Percent Distribution						
ne										
	35	35	35	35	35	35	35	35	35	35
	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25
me										
	.49	.98	1.95	3.25	4.88	8.12	9.75	11.05	11.21	11.38
ed										
	35.49	35.98	36.95	38.25	39.88	43.12	44.75	46.05	46.21	46.38
, ¥										
	32.49	29.98	24.95	18.25	9.88	-6.88	-15.25	-21.95	-22.79	-23.62
oss										
¥	160.18	1,108.06	3,073.84	4,721.64	6,086.08	-15,257.09	-70,455	-243,381.6	-561,545.6	-1,091,244
of										
	3.57	4.68	5.88	5.5	3.77	-2.92	-7.32	-11.54	-12.58	-14.32

Table 3

EXTRA BURDEN OF THE CORPORATE INCOME TAX

Items	Taxpayer A	B	C	D	E	F	G	H
1. Imputed GI (₱)	4,492.8	23,696	52,320	85,872	161,600	521,760	962,000	2,108,800
2. Gross Profit Share (₱)	492.8	3,696	12,320	25,872	61,600	221,760	462,000	1,108,800
3. Marginal Tax Rate (%)	3	6	12	20	30	50	60	68
4. Tax per ₱100 of Profits, under Integration, ₱	3	6	12	20	30	50	60	68
				I. Twenty-five Percent Distribution				
5. Corporate Income Tax, ₱[a]	35	35	35	35	35	35	35	35
6. Dividends (₱)[a]	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25
7. Individual Income Tax (₱)[a]	.49	.98	1.95	3.25	4.88	8.12	9.75	11.05
8. Joint or Combined Tax (₱)[a]	35.49	35.98	36.95	38.25	39.88	43.12	44.75	46.05
9. Extra Tax[a] (7-4), ₱	32.49	29.98	24.95	18.25	9.88	-6.88	-15.25	-21.95
10. Extra Tax on Gross Profit Share, ₱	160.18	1,108.06	3,073.84	4,721.64	6,086.08	-15,257.09	-70,455	-243,381
11. Extra Tax as % of Imputed GI (%)	3.57	4.68	5.88	5.5	3.77	-2.92	-7.32	-11.54

Table 3 (Cont'd.)

	Taxpayer									
	A	B	C	D	E	F	G	H	I	J
II. Zero Distribution										
	35	35	35	35	35	35	35	35	35	35
	32	29	23	15	5	-15	-25	-33	-34	-35
	157.76	1,071.84	2,833.60	3,880.8	3,080	-33,264	-115,500	-365,904	-837,760	-1,617,000
	3.51	4.52	5.42	4.52	1.91	-6.38	-12	-17.35	-18.77	-21.22
III. Full Distribution										
	35	35	35	35	35	35	35	35	35	35
	65	65	65	65	65	65	65	65	65	65
	1.95	3.90	7.80	13	19.50	32.50	39	44.20	44.85	45.50
	36.95	38.90	42.80	48	54.50	67.50	74	79.20	79.85	80.50
	33.95	32.90	30.80	28	24.50	17.50	14	11.20	10.85	10.50
	107.38	1,215.98	3,794.56	7,244.16	15,092	38,808	64,680	124,185.6	267,344	485,100
(%)	3.73	5.13	7.25	8.44	9.34	7.44	6.72	5.89	5.99	6.37

fits.

orate tax only, because dividends = 0.

itra tax = corporate income tax - integrated tax.

Table 3 (Cont'd.)

Items	Taxpayer A	B	C	D	E	F	G	H
				II. Zero Distribution				
12. Corporate Income Tax, (₱)[a]	35	35	35	35	35	35	35	35
13. Extra Tax, (12-4), (₱)[a, b]	32	29	23	15	5	-15	-25	-33
14. Extra Tax on Gross Profit Share (₱)	157.76	1,071.84	2,833.60	3,880.8	3,080	-33,264	-115,500	-365,904
15. Extra Tax as % of Imputed GI	3.51	4.52	5.42	4.52	1.91	-6.38	-12	-17.35
				III. Full Distribution				
16. Corporate Income Tax (₱)[a]	35	35	35	35	35	35	35	35
17. Dividends (₱)[a]	65	65	65	65	65	65	65	65
18. Individual Income Tax (₱)[a]	1.95	3.90	7.80	13	19.50	32.50	39	44.20
19. Joint Tax (₱)[a]	36.95	38.90	42.80	48	54.50	67.50	74	79.20
20. Extra Tax (₱)[a]	33.95	32.90	30.80	28	24.50	17.50	14	11.20
21. Extra Tax on Gross Profit Share (₱)	167.38	1,215.98	3,794.56	7,244.16	15,092	38,808	64,680	124,185.6
22. Extra Tax as % of Imputed GI (%)	3.73	5.13	7.25	8.44	9.34	7.44	6.72	5.88

[a] Per ₱100 of profits.

[b] Joint Tax = Corporate tax only, because dividends = 0.
In this case, extra tax = corporate income tax - integrated tax.

incomes, after which it becomes slightly regressive, and ultimately becomes approximately proportional at the topmost brackets. It follows that a tax shelter does not develop given the existing marginal bracket rates, since the maximum marginal tax rate is only 70 percent. Obviously with full distribution the extra tax is equal to the net tax,[11] as can be seen from a comparison of Tables 2 and 3.

Given the rates of personal and corporate income taxes, a certain stockholder income level may ultimately be reached where "overtaxation" dwindles and turns into "undertaxation", to use Holland's terminology. In general, the income level at which this change takes place depends on the height and progressivity of the personal income tax, the corporate income tax rates, the corporate earnings, and the dividend-payout ratio. For example, as seen in the accompanying table, the extra burden tends to be smaller, the lower the dividend-payout ratio; corollarily, the income level at which the extra burden turns into a tax shelter is reached sooner. The same holds true for more steeply progressive marginal rates of personal income tax, as can be easily verified.

This analysis of the extra burden of the corporate income tax uncovers a subtly-hidden effective discriminatory treatment in

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[11] Pechman's (1971) additional burden reduces to the net tax and the extra tax, since his analysis assumes full distribution or zero retention.

favour of high-income, and against low-income, stockholders. On this basis, the existing system of taxation of corporate earnings at the corporate and personal levels may be said to create an unequivocally regressive burden among stockholders. Graduation in the corporate income tax rate structure and the double taxation of distributed corporate profits create an impression of progressivity that in fact may be more apparent than real when seen in the light of the present analysis.

As previously stated, this tax burden comparison among stockholders makes the crucial assumption of zero shifting. Therefore, the corporate income tax falls solely on stockholders. On the other hand, full shifting to consumers or wage earners implies that there is no burden on the dividend recipient, but that the tax assumes the nature of a sales tax. With partial shifting, only part of the corporate tax to the stockholder should be credited; in this case the results will be modified, not in the general pattern, but only in magnitude (Holland, 1958). If the tax is partly shifted, it is easy to see why the problem of the tax shelter assumes greater severity, and the extra burden becomes lighter. Whether shifted or not, the present system of corporate income taxation obviously makes for an element of regressivity in the income tax structure of the Philippines.

The above analysis casts in a doubtful light the findings on the distributive effects of the corporate income tax in an earlier survey of the then Joint Legislative-Executive Tax Commission (now National

Tax Research Centre), A Study of Tax Burden by Income Class in the Philippines. The study concludes that "The mere fact that a portion of the corporate tax is shifted forward . . . a more or less regressive effect will inevitably result. With respect to the unshifted portion of the tax however, the trend is progressive. This explains why family households belonging to income class ₱10,000 and over bear the heaviest burden from this tax (Joint Legislative-Executive Tax Commission, 1964). Likewise, the report by the International Monetary Fund on the Philippine tax system seems to suggest that where the incidence of the corporate income tax is on the owners of capital, this ipso facto renders the tax progressive, as in the following statement: "... the corporate income tax, being a tax on a particular form of capital tends to reduce the rate of return on capital in general: since capital is owned very unequally, the incidence of the tax is therefore rather progressive"(International Monetary Fund, 1974). These conclusions clearly stem from a failure to consider the pattern of distribution of the corporate tax load among the owners of corporate capital in different income brackets. Studies on corporate income taxation in the Philippines have so far failed to catch this tricky aspect of the equity issue. It has been examined mainly with reference to forward shifting to consumers and the supposed long-run effects on the ownership of capital, as can be inferred from the two studies cited above.

Additionally, note that the "extra burden" does not apply solely to owners of private corporations. The same regular tax rates apply to the Government Service Insurance System (GSIS)[12], all members of which are government employees. Since most of these do not belong to the high income brackets, the extra burden rather than the tax shelter aspect may be quite significant.

The burden differential created by the corporate income tax has likewise been examined by Holland (1958) using U.S. data. The author uses four variants of differentials, namely, (1) differential against earnings for distribution, (2) differential against earnings for retention, (3) differential against earnings, and (4) differential against stockholders' income. The patterns of distribution that emerged are very similar, differing only in magnitude or degree: the corporate income tax load on stockholders rapidly decreases after reaching some income level. Hence again, unequivocally, a regressive burden distribution among stockholders. The need for a similar investigation for the Philippines cannot be gainsaid, but for the moment these tests cannot be applied due to the ubiquitous overriding constraint imposed by non-availability of data.

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[12]This was provided for by Presidential Decree No. 1177, dated 30 July 1977.

D. Extra Burden with Proposed 20 Percent Final Tax on Dividends Under Cabinet Bill No. 34

A gradual shift in approach to income taxation is taking place in the Philippines: from the global or universal to the schedular, whereby the tax treatment varies according to the type of income. Already, certain types of capital gains and interest incomes have been subject to different rates of final tax, and are no longer to be included with the other types of incomes in determining the overall gross and net taxable incomes (P.D. 1739, 17 September 1980). This schedular approach is part of the tax amendments proposed under Cabinet Bill No. 34, filed with the Interim Batasang Pambansa under the sponsorship of the Minister of Finance. The major revision in the bill is the shift from net income to what has been termed "modified" gross income taxation, with a corresponding revision of the marginal tax brackets and marginal tax rates, levels of exemption, and types and levels of allowable deductions.

This section will focus on the proposed revision of dividend taxation. The Bill seeks to impose a final withholding tax of 20 percent on so-called "passive incomes" which include dividends, royalties, interest, prizes and other winnings.

A comparison is made here of extra burden under the present system of corporate-personal income taxation (with dividends as part

of overall gross income) and under the same system, but with dividends taxed separately at 20 percent. Hence the only change will be the proposed 20 percent final tax on dividends being grafted on to the existing system of net income taxation. An objection may be raised against this procedure, because the gross income tax and the final tax on dividends have been proposed as a package. Lately however, doubts have increased as to the need for, and desirability of, shifting to the proposed gross income tax. Therefore, while the latter may not be approved, a final tax on dividends may still be imposed, as has already been done with respect to certain types of capital gains and interest incomes.

Table 4 employs the same assumptions as in the previous section. The only difference between the present and the proposed approach is the final tax on dividends. With the proposed final tax the extra burden is clearly heavier and the tax shelter greater than under the present system, for both 25 percent and 100 percent pay-out. Specifically, even with full distribution, the pattern changes from a heavy extra tax to a tax shelter of considerable magnitude. Under the present scheme however, the extra tax is lighter for the lower income brackets, and remains positive throughout the entire range. Only with zero distribution is there equality between the present and proposed schemes. The flat rate tax on dividends is easily regressive with respect to stockholders' incomes and will only intensify the existing regressivity.

Table 4

Table 4

EXTRA BURDEN OF THE CORPORATE INCOME TAX, PRESENT AND PROPOSED
(Under Cabinet Bill No. 34)

	Taxpayer									
	A	B	C	D	E	F	G	H	I	J
	4,492.8	23,696	52,320	85,872	161,600	521,760	962,000	2,108,800	4,464,000	7,620,000
are (₱)	492.8	3,696	12,320	25,872	61,600	221,760	462,000	1,108,800	2,464,000	4,620,000
te (%)	3	6	12	20	30	50	60	68	69	70
per										
s (₱)	3	6	12	20	30	50	60	68	69	70
				I. Twenty-five Percent Distribution						
er Cabinet Bill No. 34										
e Tax (₱)[a]	35	35	35	35	35	35	35	35	35	35
	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25	16.25
% on										
	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25	3.25
,b	38.25	38.25	38.25	38.25	38.25	38.25	38.25	38.25	38.25	38.25
ess	35.25	32.25	26.25	18.25	8.25	-11.75	-21.75	-29.75	-30.75	-31.75
₱)	173.78	1,191.96	3,234	4,721.64	5,082	26,056.8	-100,485	-329,868	-757,680	1,466,850
rcent (%)	3.87	5.03	6.18	5.5	3.14	-4.99	-10.45	-15.64	-16.97	-19.25

rofits
e corporate income tax and the final tax on dividends.

Table 4

EXTRA BURDEN OF THE CORPORATE INCOME TAX, PRESENT AND PROPOSED
(Under Cabinet Bill No. 34)

Item	Taxpayer A	B	C	D	E	F	G
1. Imputed GI (₱)	4,492.8	23,696	52,320	85,872	161,600	521,760	962,0
2. Gross Profit Share (₱)	492.8	3,696	12,320	25,872	61,600	221,760	462,0
3. Marginal Tax Rate (%)	3	6	12	20	30	50	
4. Integrated Tax per ₱100 of Profits (₱)	3	6	12	20	30	50	
I. Twenty-five Percent Distribution							
A. As Proposed under Cabinet Bill No. 34							
5. Corporate Income Tax (₱)[a]	35	35	35	35	35	35	
6. Dividends (₱)[a]	16.25	16.25	16.25	16.25	16.25	16.25	
7. Final Tax of 20% on Dividends (₱)[a]	3.25	3.25	3.25	3.25	3.25	3.25	
8. Joint Tax (₱)[a]	38.25	38.25	38.25	38.25	38.25	38.25	
9. Extra Tax (₱)[a,b]	35.25	32.25	26.25	18.25	8.25	-11.75	
10. Extra Tax on Gross Profit Share (₱)	173.78	1,191.96	3,234	4,721.64	5,082	26,056.8	-100,4
11. Extra Tax as Percent of Imputed GI, (%)	3.87	5.03	6.18	5.5	3.14	-4.99	

[a] Per ₱100 of Profits
[b] Due both to the corporate income tax and the final tax on dividends.

Table 4 (Cont'd.)

	Taxpayer									
a	35.49	35.98	36.95	38.25	39.88	43.12	44.75	46.05	46.21	46.38
₱100 of	32.49	29.98	24.95	18.25	9.88	-6.88	-15.25	-21.95	-22.79	-23.62
Gross (₱)	160.18	1,108.06	3,073.64	4,721.64	6,086.08	-15,257.09	-70,455	-243,381.6	-561,545.6	-1,091,244
% of %)	3.57	4.68	5.88	5.5	3.77	-2.92	-7.32	-11.54	-12.58	-14.32
				II. Zero Distribution						
nder No. 34										
ome	35	35	35	35	35	35	35	35	35	35
	0	0	0	0	0	0	0	0	0	0
)	35	35	35	35	35	35	35	35	35	35
	32	29	23	15	5	-15	-25	-33	-34	-35
Gross (₱)	157.76	1,071.84	2,833.60	3,880.8	3,080	-33,264	-115,500	-365,904	-837,760	-1,617,000
% of %)	3.51	4.52	5.42	4.52	1.91	-6.38	-12	-17.35	-18.77	-21.22

same as II.A. above.

00 of Profits.

to the corporate tax only.

Table 4 (Cont'd.)

Table 4 (Cont'd.)

Item	Taxpayer							
B. Present System								
12. Joint Tax (₣)[a]	35.49	35.98	36.95	38.25	39.88	43.12	44.75	46.05
13. Extra Tax per ₣100 of Profit (₣)[a]	32.49	29.98	24.95	18.25	9.88	-6.88	-15.25	-21.95
14. Extra Tax on Gross Profit Share (₣)	160.18	1,108.06	3,073.84	4,721.64	6,086.08	-15,257.09	-70,455	-243,381.6
15. Extra Tax as % of Imputed GI (%)	3.57	4.68	5.68	5.5	3.77	-2.92	-7.32	-11.64
				II. Zero Distribution				
A. As Proposed, Under Cabinet Bill No. 34								
16. Corporate Income Tax (₣)	35	35	35	35	35	35	35	35
17. Dividends (₣)	0	0	0	0	0	0	0	0
18. Joint Tax[b] (₣)	35	35	35	35	35	35	35	35
19. Extra Tax (₣)	32	29	23	15	5	-15	-25	-33
20. Extra Tax on Gross Profit Share (₣)	157.76	1,071.84	2,833.60	3,880.8	3,080	-33,264	-115,500	-365,904
21. Extra Tax as % of Imputed GI (%)	3.51	4.52	5.42	4.52	1.91	-6.98	-13	-17.33
B. Present System same as II.A. above.								

[a]Per ₣100 of Profits.

[b]Equal to the corporate tax only.

Table 4 (Cont'd.)

	Taxpayer									
	A	B	C	D	E	F	G	H	I	J
				III. Full Distribution						
come										
	35	35	35	35	35	35	35	35	35	35
)	65	65	65	65	65	65	65	65	65	65
(₱)	13	13	13	13	13	13	13	13	13	13
(₱)	48	48	48	48	48	48	48	48	48	48
(₱)	45	42	36	28	18	-2	-12	-20	-21	-22
Gross										
(₱)	221.85	1,552.32	4,435.20	7,244.16	11,088	-4,435.2	-55,440	-221,760	-517,440	-1,016,400
% of										
	4.94	6.55	8.48	8.44	6.86	-.85	-5.76	-10.52	-11.59	-13.34
)[a]	36.95	38.90	42.80	48	54.50	67.50	74	79.20	79.85	80.50
)[a]	33.95	32.90	30.80	28	24.50	17.50	14	11.20	10.85	10.50
Gross										
	167.38	1,215.98	3,794.56	7,244.16	15,092	38,808	64,680	124,185.6	267,344	485,100
% of										
	3.73	5.13	7.25	8.44	9.34	7.44	6.72	5.89	5.99	6.37

Profits.
the corporate income tax and the final tax on dividend.

0 of Profits.
o the corporate tax only.

Table 4 (Cont'd.)

	Taxpayer							
	A	B	C	D	E	F	G	H
III. Full Distribution								
A. As Proposed								
22. Corporate Income Tax[a] (₱)	35	35	35	35	35	35	35	
23. Dividends[a] (₱)	65	65	65	65	65	65	65	
24. Final Tax on Dividends[a] (₱)	13	13	13	13	13	13	13	
25. Joint Tax[a] (₱)	48	48	48	48	48	48	48	
26. Extra Tax[a,b] (₱)	45	42	36	28	18	-2	-12	
27. Extra Tax on Gross Profit Share (₱)	221.85	1,552.32	4,435.20	7,244.16	11,088	-4,435.2	-55,440	-221,7
28. Extra Tax as % of Imputed GI	4.94	6.55	8.48	8.44	6.86	-.85	-5.70	
B. Present System								
29. Joint Tax (₱)[a]	36.95	38.90	42.80	48	54.50	67.50	74	
30. Extra Tax (₱)[a]	33.95	32.90	30.80	28	24.50	17.50	14	
31. Extra Tax on Gross Profit Share	167.38	1,215.98	3,794.56	7,244.16	15,092	38,808	64,680	124,1
32. Extra Tax as % of Imputed GI	3.73	5.13	7.25	8.44	9.34	7.44	6.72	

[a] Per ₱100 of Profits.
[b] Due both to the corporate income tax and the final tax on dividend.

Whether under the existing system of net income taxation or under a system of gross income taxation, the corporate profits tax together with the proposed final tax on dividends will result in greater regressivity of the tax burden distribution. The final tax on dividends which is a tax *in rem*, and the corporate tax do not allow for variations in, and are determined independently of, stockholders' incomes.

IV. Tax Shelter and the Accumulation of Corporate Surplus

The tax shelter hypothesis brings to clearer focus the related issue of corporate surplus accumulation. The lower or negative "extra burden" provides a strong incentive for incorporation, or where this has been done, for high income stockholders to capitalize on the corporate structure to effect tax savings, the maximum opportunity provided by a family or closely-held corporation. As pointed out earlier, for any given mix of stockholder incomes, and corporate and personal income tax rates, the extra burden is less and the tax shelter is greater, the lower the dividend payout ratio.

Theoretically, the corporate payout ratio may be expected to vary inversely with the differential between the tax rates on ordinary income and capital gains.[13] Shareholders are likely to

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[13] This hypothesis is discussed by John A. Brittain in Corporate Dividend Policy (Washington: Brookings Institution, 1966).

favour lower dividends the bigger the size of this differential because of the tax shelter created by corporate retention. One may argue that the tax advantage from retention may very well be temporary, because either the corresponding capital gains will be realized, or dividends will ultimately be paid out. While this is true, the tax advantage may nevertheless be created in any of several ways. One is the lower tax liability generally attached to long-term capital gains. For sometime now this has been true for many types of capital gains in the Philippines, so that a differential has existed between the effective tax rates on ordinary income (which includes dividends) and long-term capital gains. More recently, with P.D. 1739, as mentioned in the section on Debt vs. Equity Capital, gains from stock transactions are subject to a flat rate of tax which favours high income stockholders.

Secondly, because taxation is on a realization rather than on an accrual basis, the tax on capital gains may be avoided completely if the gains are unrealized at the time of the stockholder's death, although subsequently realized by heirs. Thirdly, should the accumulated surplus be ultimately paid out as dividends, there will be an advantage in the form of tax deferral which is equivalent to an interest-free loan.

Another possibility is that dividends may be disguised as directors' and managers' bonuses, allowances, or fees, where the

corporate decision makers also have equity interest in the enterprise, usually in family or closely-held corporations. Finally, in the Philippines, capital gains may escape taxation altogether if the proceeds are invested in certain enterprises like the preferred enterprises covered by the Investment Incentives Act and the Export Incentives Act, and, under the latest amendment (P.D. No. 1738, dated 17 September 1980), banks and non-bank financial intermediaries subject to certain conditions.

The tax shelter hypothesis rests on any of a number of assumptions (Brittain, 1966) most important of which are the following: (1) that a substantial number of owners possess sophistication to perceive the potential for tax savings through retention; (2) that the corporate owners expect low dividend yields to be more than offset by higher dividends in future, and/or by capital gains taxed at lower rates;[14] (3) that the owners' interests are known and respected by the corporate decision makers; and (4) that there exists confidence on the part of the latter that stockholders will not interpret a dividend lag as an ominous indication of future prospects. From these assumptions, it follows that the tax shelter effect on the payout ratio is likely to be stronger the more closely held the corporation.

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[14] As previously mentioned realized capital gains may not even be taxed at all.

Apart from these assumptions, it is further necessary to establish some criteria or benchmark as to what constitute unreasonable retention and accumulation of corporate profits, allowing for variations in different industries. These tests relate to, among others, the required level of reserves, loans to stockholders and other corporations, business or plant expansion plans, indebtedness of the corporation, working capital requirements, types and size of corporate investments in other enterprises, properties or securities, etc.

Empirical verification is again essential in this regard. Inquiries and studies have been conducted in the United States seeking to define the significance of individual income tax considerations in corporate dividend policies. These include a Congressional Report (Hall, 1952), confidential interviews with corporate officials (Lintner, 1956) as well as studies on stock ownership and on tax rates and tax differentials (Atkinson, 1949; Cox, 1963; Bailey, 1969; Brittain, 1966). Most of these confirmed the positive effect of individual income tax factors on corporate distribution policies.

Unfortunately in the Philippines, studies in this area have yet to be made and probably will take a long time. The potential for exploiting the corporation for tax avoidance has been recognized, however, as evidenced by the surtax on personal holding companies[15]

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[15]The surtax is 45 percent of the undistributed income of the personal holding company (Sec. 63 of the NIRC).

and on improper accumulation of profits[16] imposed under the National Internal Revenue Code.[17] The surtax is in addition to the regular rates of corporate income tax. This penalty has not been a strong deterrent, however, according to revenue officials themselves. Generally the attitude has been to ride the issue or sweep it under the rug, possibly for pragmatic reasons, or simply from the usual inertia syndrome.

The pragmatic reasons may cover a broad spectrum, ranging from the genuinely patriotic to the more self-oriented. An example of the former was indicated in an interview with a high-ranking official of the Ministry of Finance who remarked that strict implementation of the penalty provisions may create disincentives and adverse effects on the balance of payments via increased profit remittances abroad. It has also been gathered in an interview with a representative from a multi-national corporation that their company is caught in a bind between Central Bank restrictions on profit remittances and the surtax on corporate surplus accumulations. There is, in addition, a 15 percent tax on profit remittances abroad by a branch office to its mother company. (See Sec. 24 (b) (2)(b) of the NIRC, as amended by P.D. 1705 on 1 August 1980). This Scylla-and-Charybdis syndrome cannot but

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[16]The surtax is 25 percent of the undistributed portion of the company's accumulated profits or surplus. (Sec. 25).

[17]P.D. No. 1739 (dated 17 September 1980) expanded the list of corporations exempt from the surtax.

arise as a result of conflicting government measures. Admittedly it is operationally difficult to determine and prove improper or unreasonable accumulation of corporate profits. Until very recently no precise benchmarks or criteria had been adopted to reckon what constituted unreasonable accumulation. It has been gathered that this was largely left to the discretion of the internal revenue examiner. As a rule of thumb, the size of the accumulated surplus relative to the paid-in equity capital was generally used. For some examiners, there was cause for suspicion if the size of the accumulated surplus exceeded 100 percent of the paid-in equity. For more liberal examiners however, the ceiling ratio was two to one. Even at such level of capital accumulation, the corporation could still avoid paying the surtax if it was able to prove that the accumulation was not unreasonable by invoking any of the following justifications: plans for expansion, servicing of bonded obligations, need for working capital, and low cash position.[18] Obviously, there was a wide margin of uncertainty, not to say room for bargaining, in implementing the penalty provisions.

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[18] It has been gathered that the government has won in only a very small number of tax cases on the question of corporate surplus accumulation. Among the firms involved were Basilan Estates and Manila Wine Merchants. The most recent case was against Ayala Securities Corporation, which was ordered by the Supreme Court to pay a ₱.7 million surtax.

To correct this loophole, the Interim Batasang Pambansa incorporated in the New Corporation Code of the Philippines (Batas Pambansa Blg. 68, approved 1 April 1980) a provision prohibiting stock corporations from "retaining surplus profits in excess of one hundred percent of their paid-in capital stock, except: (1) when justified by definite corporate expansion projects or programs approved by the Board of Directors; or (2) when the corporation is prohibited under any loan agreement with any financial institution or creditor, whether local or foreign, from declaring dividends without its/his consent, and such consent has not yet been secured; or (3) when it can be clearly shown that such retention is necessary under special circumstances obtaining in the corporation, such as when there is a need for special reserve for probable contingencies. (Sec. 43). Whether this provision can effectively curb tax avoidance through retention of corporate surplus, only time can tell. Much of the unknown factor lies in the quality of the revenue examiners.

A major change proposed by Cabinet Bill No. 34 is the equalization in the tax treatment of corporate profits and business incomes of individuals. The same marginal tax rates will apply to both, ranging from 15 percent to 40 percent. This parity may reduce the tax advantage from incorporation, but for an already existing corporation it is not likely to diminish efforts towards corporate profit retention because the effective surtax or higher tax burden on distributed profits will continue to be incurred.

The fact remains that a tax shelter or a major avenue for individual tax avoidance is irrevocably created by the present non-integration of the corporate and personal income taxes, through the retention of earnings by corporations.[19] "With the corporation as a recognized legal entity apart from the individual taxpayer, the corporation can be interposed between the source of income and its receipt by the individual owner" (Hall, 1952). The problem exists from "applying the personal income tax in a world thickly populated with fictitious personalities owned by non-fictitious persons" (Proceedings of the National Tax Association, 1938). Pursuing the matter to its logical conclusion, one must recognize that "if savings in general are taxed as income, there should be no exemption of the savings of certain individuals whose investments take the legal form of shares in corporations that do not distribute their earnings promptly and completely" (Proceedings of the National Tax Association, 1939).

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[19] On the other hand, tax evasion may also take place in the case of dividends received. The 10 percent withholding tax on dividends, which is credited against the stockholder's overall income tax liability compels reporting only where the tax withheld is greater than the tax due on dividends. For individuals with marginal tax rates of 12 percent and above, there is a clear advantage from non- or under-reporting.

In a society like the Philippines where there are a large number of closely-held corporations and interlocking directorates,[20] the tax shelter carries serious equity implications apart from creating non-neutral effects on the form of business organization and corporate dividend policy which are not justified by economic considerations.

IV. Concluding Remarks

The present inquiry has been undertaken from a largely theoretical perspective, relying heavily on hypothetical data and simplifying assumptions. Economic theory can only demonstrate the existence of burden differential and its inexorable regressivity in the present scheme of corporate cum dividend taxation. The ultimate test will require the use of empirical data based on reliable actual tax returns of taxpayers and corporations, such as the gross and taxable incomes of stockholders, dividend and capital gains components of stockholders' incomes, proceeds from the surtax on accumulated surplus and personal holding companies, etc. Here and now the prospects of extricating these information from the Bureau of Internal Revenue are not at all sanguine, for any of a

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[20] For an interesting study on this, see John Doherty, A Preliminary Study of Interlocking Directorates, Manila, 1979.

number of reasons (alleged confidentiality of information, non-reliability, non-collection, or non-consolidation of data) which stand in the way of serious efforts to study the Philippine tax system. Nevertheless, it is believed that in time to come the conclusions that have emerged will be confirmed by empirical findings. No significant departure is expected from the above pattern; whatever deviations may arise will not be one of direction, but only of magnitude.

A disturbing note comes from the proposed final tax on dividend which will render the combined burden more regressive. This is in contrast with the practice in some Asian countries to relieve stock-holders from double taxation of distributed earnings. Cabinet Bill No. 24 seeks, according to the Explanatory Note, "to rationalize the taxation of different types of income." It remains unclear what the basis and the objective are of such "rationalization". Priorities among objectives have to be realized and made explicit, because policy measures can and do create conflicts in the pursuit of these objectives. Does the strength of the proposal rest on equity, or on incentive considerations? These two objectives are very closely intertwined in the present instance. While the resulting tax shelter may indeed further the incentive for investment in corporate stock on the part of high-income individuals, the inequity from the heavier (extra) burden may create disincentive effects among the lower and middle income taxpayers. Naturally this will create further effects on wealth accumulation and income distribution.

Annex

Sometime after the completion of this paper, President Marcos issued P.D. No. 1773, dated 16 January 1981, amending certain sections of the National Internal Revenue Code on personal and corporate income taxation. There are two major amendments relevant to the present paper, namely, 1) payment of the corporate development tax by closely-held corporations only, with an increase in its rate from 5 percent to 10 percent, and 2) increase in the level of personal and additional exemptions. The new exemption levels, applicable to 1980 incomes, are as follows:

1. If taxpayer is single, or legally separated from his or her spouse, ₱3,000.00.
2. If taxpayer is married or head of family, ₱6,000.00
3. For each dependent child (maximum of four), ₱2,000.00.

The above changes do not materially affect the findings of the study.

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